# International Business Environments and Operations, 13/e

## Part 4

## World Financial Environment



# Chapter 10

# The Determination of Exchange Rates

# Chapter Objectives

- To describe the international monetary fund and its role in the determination of exchange rates
- To discuss the major exchange-rate arrangements that countries use
- To explain how the European monetary system works and how the euro became the currency of the euro zone
- To identify the major determinants of exchange rates
- To show how managers try to forecast exchange-rate movements
- To explain how exchange rate movements influence business decisions

# International Monetary Fund

- Objectives of the IMF
  - To ensure stability in the international monetary system
  - To promote international monetary cooperation and exchange-rate stability
  - To facilitate the balanced growth of international trade
  - To provide resources to help members in balance-of-payments difficulties or to assist with poverty reduction

# The Bretton Woods Agreement

The Bretton Woods Agreement established a par value, or benchmark value, for each currency initially quoted in terms of gold and the U.S. dollar.

# The IMF Today

- The Quota System
- Assistance Programs
- Special Drawing Rights (SDRs)
  - The Global Financial Crisis and the SDR

# Evolution to Floating Exchange Rates

- The Smithsonian Agreement
  - 8% devaluation of the dollar
  - Revaluation of other currencies
  - Widening of exchange rate flexibility
- The Jamaica Agreement

# Exchange Rate Arrangements

| Exchange rate arrangement | Exchange rate anchor | | | | Monetary Policy Framework | | | |
|---|---|---|---|---|---|---|---|---|
| | US dollar | Euro | Composite | Other | Monetary aggregate target | Inflation-targeting | Other | Total |
| Exchange rate arrangement with no separate legal tender | 7 | 2 | | 1 | | | | 10 |
| Currency board arrangement | 8 | 4 | | 1 | | | | 13 |
| Other conventional fixed-peg arrangement | 36 | 20 | 7 | 5 | 4 | | | 72 |
| Pegged exchange rate within horizontal bands | | 1 | 2 | | | | | 3 |
| Crawling peg | 6 | | 2 | | | | | 8 |
| Crawling band | 1 | | 1 | | | | | 2 |
| Managed floating with no pre-determined path for the exchange rate | 8 | | 3 | | 17 | 10 | 6 | 44 |
| Independently floating | | | | | 1 | 34 | 5 | 40 |
| Total | 66 | 27 | 15 | 7 | 22 | 44 | 11 | 192 |

*Source:* Adapted from the International Monetary Fund, "De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks," http://www.imf.org/external/np/mfd/er/2008/eng/0408.htm (April 30, 2008).

# Exchange Arrangements with No Separate Legal Tender

- Dollarization
- Currency Board Arrangements
- Pegged Arrangements
- More Flexible Arrangements
  - Crawling Pegs
  - Managed Float
  - Independently Floating

# Exchange Rates: The Bottom Line

Countries may change the exchange-rate regime they use, so managers need to monitor country policies carefully.

# The Euro

- The European Monetary System and the European Monetary Union
- Pluses and Minuses of the Conversion to the Euro
- The Euro and Global Financial Crisis

# The Chinese Yuan

- Playing it SAFE
- The Global Financial Crisis and the Future of the CNY

# Determining Exchange Rates

- Non-intervention: Currency in a floating rate world
- Intervention: Currency in a fixed rate or managed floating rate world

# The Role of Central Banks

- Central Bank Reserve Assets
- How Central Banks Intervene in the Market
  - Different attitudes toward intervention
  - Challenges with intervention
  - Revisiting the BIS

# Black Markets

A black market closely approximates a price based on supply and demand for a currency instead of a government controlled price.

# Foreign Exchange Convertibility and Controls

- Hard and soft currencies
- Controlling Convertibility
  - Licensing
  - Multiple Exchange Rates
  - Import Deposits
  - Quality Controls

# Exchange Rates and Purchasing Power Parity

- The Big Mac Index
- Short Run problems that affect PPP

# Exchange Rates and Interest Rates

- The Fisher Effect
- The International Fisher Effect
- Other Factors in Exchange Rate Determination
  - Confidence
  - Information

# Forecasting Exchange Rate Movements

- Fundamental and Technical Forecasting
  - Dealing with biases
  - Timing, Direction, Magnitude

# Fundamental Factors to Monitor

- Institutional Setting
- Fundamental Analyses
- Confidence Factors
- Circumstances
- Technical Analyses

# Business Implications of Exchange Rate Changes

- Marketing Decisions
- Production Decisions
- Financial Decisions

# Future:

- Latin America
  - Emerging market currencies should strengthen as commodity prices recover
- Europe
  - The euro is gaining popularity and will take market share away from the dollar as the prime reserve asset
- Asia
  - China is moving forward to establish the yuan as a major world currency